

Message Text

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ACTION EB-07

INFO OCT-01 ARA-06 ISO-00 AID-05 CIAE-00 COME-00 FRB-03

INR-07 NSAE-00 USIA-06 TRSE-00 XMB-02 OPIC-03 SP-02

CIEP-01 LAB-04 SIL-01 OMB-01 NSC-05 SS-15 STR-04

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R 141720Z SEP 76

FM AMEMBASSY SANTIAGO

TO SECSTATE WASHDC 1369

INFO AMEMBASSY BOGOTA

AMEMBASSY BRASILIA

AMEMBASSY BUENOS AIRES

AMEMBASSY CARACAS

AMEMBASSY LA PAZ

AMEMBASSY LIMA

AMEMBASSY QUITO

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E. O. 11652: N/A

TAGS: EFIN, AFIN, CI

SUBJECT: INFLATIONARY EXPECTATIONS MODERATING?

REF: SANTIAGO 8651

1. SUMMARY. THE SURPRISE TEN PERCENT REVALUATION OF THE PESO ON JUNE 30, IN A SITUATION OF STILL VERY HIGH INFLATION, REPRESENTED AN EFFORT TO BREAK INFLATIONARY EXPECTATIONS. TO SOME EXTENT THE GOC INFLATION STRATEGY HAS SUCCEEDED: PRICES ROSE IN AUGUST AT AN ANNUALIZED RATE OF 90 PERCENT, ABOUT HALF THE RATE AT WHICH THEY HAD BEEN RISING DURING EACH OF THE FIRST SIX MONTHS OF 1976, BUT STILL TOO HIGH FOR A STABLE ECONOMIC SYSTEM. THE GOC HOPES TO GET THE RATE DOWN TO WELL BELOW FIVE PERCENT PER MONTH BY THE END OF THE YEAR. PORTENTS ARE BOTH FAVORABLE AND UNFAVORABLE. OUR JUDGMENT IS THAT INFLATION WILL CONTINUE TO

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EASE OFF SOMEWHAT IN THE MONTHS AHEAD. AT THE SAME TIME, IT

WILL CONTINUE AT RATES AMONG THE HIGHEST IN THE WORLD AND WILL CONSTITUTE A SUBSTANTIAL ECONOMIC AND SOCIAL PROBLEM FOR SOME TIME TO COME. (BY SEPARATE MESSAGES THE EMBASSY WILL ANALYZE THE SPECIAL PROBLEM CREATED BY RAPID PRICE INCREASES IN STAPLE CONSUMER ITEMS, PARTICULARLY WHEN COMBINED WITH LAGS IN THE DEVALUATION OF THE PESO AGAINST THE DOLLAR, FOR BOTH CHILEAN CONSUMERS AND U.S. OFFICIAL FAMILIES IN SANTIAGO). END SUMMARY.

2. THE JUNE 30 PERCENT REVALUATION OF THE PESO HAD A PRONOUNCED IMPACT ON PRICE CHANGES IN JULY AND AUGUST. DURING THE FIRST SIX MONTHS OF 1976, INFLATION HAD AVERAGED 11.4 PERCENT MONTHLY. THE JUNE RATE WAS 12.3 PERCENT. THE JULY RATE FELL TO 8.9 PERCENT AND THE AUGUST RATE TO 5.5 PERCENT. LAGGING EXCHANGE RATE DEPRECIATIONS IN RELATION TO THE DOMESTIC RATE OF PRICE CHANGE DURING JUNE AND JULY ALSO HELPED TO HOLD DOWN INFLATION IN JULY AND AUGUST.

3. INDEED THE INFLATIONARY SITUATION MIGHT HAVE BEEN EVEN BETTER IN JULY AND AUGUST WERE IT NOT FOR A LARGE INFLOW OF CAPITAL AT THE BEGINNING OF JULY. CHILE'S HIGH INTEREST RATES TOGETHER WITH A PREVIOUS (UNSTATED) POLICY OF DEVALUING THE PESO AT A SLOWER RATE THAN INCREASES IN THE LOCAL PRICE LEVEL CREATED A VERY LARGE INTEREST RATE DIFFERENTIAL BETWEEN THE DOMESTIC AND FOREIGN MONEY MARKETS. SHORT-TERM LOAN PLACEMENT WITH CHILEAN FINANCIAL INSTITUTIONS THUS BECAME PARTICULARLY ATTRACTIVE TO FOREIGN SOURCES OF FINANCE. THOSE INFLOWS DIRECTLY SWELLED THE MONEY SUPPLY (WHICH PRINCIPALLY FOR THIS, BUT ALSO OTHER REASONS, GREW BY 15.7 PERCENT IN THAT MONTH) AND COMPOUNDED INFLATIONARY PRESSURES.

4. THERE ARE INDICATIONS THAT INFLATIONARY PRESSURES WILL CONTINUE TO DIMISH IN THE MONTHS AHEAD. A) CAPITAL INFLOWS, WHICH HAD BEEN THE MAJOR SOURCE OF MONEY SUPPLY EXPANSION IN RECENT MONTHS, ARE UNDER BETTER MANAGEMENT AS A RESULT OF TIGHTENED FOREIGN EXCHANGE CONTROLS ON SHORT-TERM CAPITAL MOVEMENTS; B) LOCAL SAVINGS AND LOAN ASSOCIATIONS ARE NOW LARGELY ABLE TO COPE WITH THEIR LIQUIDITY PROBLEMS WITHOUT RECOURSE TO CENTRAL BANK FINANCING; C) NO LARGE DISTURBANCES TO THE CHILEAN PRICE STRUCTURE ARE ANTICIPATED

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FROM THE FOREIGN SECTOR IN THE NEXT FEW MONTHS; D) A GRADUAL EASING OF INTEREST RATES SUGGESTS THAT FINANCIERS EXPECT A LOW RATE OF INFLATION (IN THE CHILEAN ECONOMY INFLATIONARY EXPECTATIONS, AT LEAST IN THE SHORT RUN, TEND TO GET VALIDATED).

5. OTHER SIGNS, HOWEVER, ARE LESS HOPEFUL. A) UNDER THE QUARTERLY SYSTEM OF WAGE ADJUSTMENTS CHILEAN WORKERS ARE ENTITLED TO A 26 PERCENT PAY BOOST IN SEPTEMBER. MERCHANTS ANTICIPATE THE

ADDITIONAL DEMAND RESULTING FROM HIGHER INCOMES WITH SUBSTANTIAL PRICE INCREASES. UNTIL SUCH TIME AS A WAGE ADJUSTMENT SYSTEM IS DEvised WHICH MODERATES SHARP SURGES IN DEMAND, IT IS MOST LIKELY THAT HIGHER NOMINAL WAGES WILL CONTINUE TO BE ASSOCIATED WITH A HIGHER PRICE LEVEL. B) THE GOC IS UNLIKELY TO CONTINUE A POLICY OF MOVING THE EXCHANGE RATE AT A SLOWER RATE THAN THE COP. (BETWEEN OCTOBER 1975 AND SEPTEMBER 1976 THE CPI INCREASED AT A 26 PERCENT FASTER RATE THAN THE PESO DOLLAR EXCHANGE RATE.) C) PROSPECTS FOR VEGETABLE AND FRUIT CROPS HAVE BEEN DIMMED IN SOME OF THE PRINCIPAL GROWING AREAS BY A SEVERE DROUGHT. USUALLY, SHARP DECLINES IN THE RELATIVE PRICES OF FOODSTUFFS DURING THE OCTOBER-DECEMBER PERIOD HELP BRAKE THE RATE OF INCREASE IN THE GENERAL PRICE LEVEL.

6. A FINAL CONSIDERATION IS THE RELATIVE WEIGHT THE GOC ASSIGNS TO PRICE STABILITY OBJECTIVES AS OPPOSED TO THOSE OF OUTPUT AND EMPLOYMENT IN ITS ORDER OF ECONOMIC PRIORITIES. SO FAR THE GOC SEEMS TO BE ATTACHING GREATER IMPORTANCE TO THE FORMER THAN THE LATTER. FISCAL POLICY CONTINUES TO BE VERY CONSERVATIVE AND MONETARY POLICY ABOUT AS TIGHT AS THE MONETARY AUTHORITIES CAN MANAGE, GIVEN THE CONSTRAINTS WITHIN WHICH THEY OPERATE. WE EXPECT SOME EASING UP IN THE BUDGET FOR CY 1977, WHETHER OR NOT INFLATION CONTINUES AT IS PRESENT UNCOMFORTABLE RATE.
POPPER

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